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Management Alert

California Supreme Court Rejects the Federal "Narrow Restraint Exception"

And Holds That Employment Non-Competition Agreements Are Invalid Unless They Fall Within Limited Statutory Exceptions

On August 7, 2008, the California Supreme Court, in the highly anticipated decision *Edwards v. Arthur Andersen LLP,* decided that California Business and Professions Code section 16600 prohibits all employee non-competition agreements, unless the agreement falls within limited statutory exceptions. The Court held "[u]nder the statute's plain meaning . . . an employer cannot by contract restrain a former employee from engaging in his or her profession, trade, or business unless the agreement falls within one of the exceptions to the rule." In doing so, the Court provided a bright-line rule, expressly rejecting the federal "narrow restraint exception" used by some courts to construe section 16600 as permitting non-competition agreements, where one is barred from pursuing only a small or limited part of a business, trade, or profession.

The decision reaffirms that non-competition agreements between employers and employees are void in California, and goes one step further to state that such agreements *are invalid unless they fall within narrow statutory exceptions* to section 16600, exceptions rarely found in the typical employment relationship. The exceptions to the rule are non-competition agreements in the sale or dissolution of corporations (§ 16601), partnerships (§ 16602), and limited liability corporations (§ 16602.5). Covenants in employment agreements providing for ancillary restraints on employees, such as clauses providing for the forfeiture of stock options upon joining a competitor, will not likely be upheld. Employers with such provisions run the risk not only of courts invalidating the agreements, but also of being sued for interfering with an employee's ability to obtain new employment.

The *Edwards* Court, however, specifically did not address whether a trade secret exception exists to section 16600, which may permit non-solicitation of customer clauses, to the extent that such clauses are necessary to protect trade secrets, such as qualifying customer lists. To attempt to enforce a non-solicitation of customers clause, companies will need to demonstrate that their customer lists and related customer information are trade secrets.

The *Edwards* Court also held that contract provisions (often found in settlement agreements with employees)

requiring employees to release "any and all" claims against the employer do not, per se, cover nonwaivable statutory protections, such as the employee indemnity protections of California Labor Code section 2802, which requires employers to indemnify employees for all necessary expenditures or losses incurred by the employee in discharging their employment duties.

Facts at Issue/Procedural Posture

Raymond Edwards, a CPA, was required to sign a non-competition agreement as a condition of his employment with the Arthur Andersen accounting firm. The two clauses at issue in Edwards' non-competition agreement with Andersen provided:

1) If you leave the Firm, for eighteen months after release or resignation, you agree not to perform professional services of the type you provided for any client on which you worked during the eighteen months prior to release or resignation. This does not prohibit you from accepting employment with a client.

2) For twelve months after you leave the Firm, you agree not to solicit (to perform professional services of the type you provided) any client of the office(s) to which you were assigned [Los Angeles] during the eighteen months preceding release or resignation.

When Andersen sold its Los Angeles tax practice, it required Edwards to sign a "Termination of Non-Compete Agreement" (TONC) as a condition of releasing Edwards from the non-competition agreement. When Edwards refused to sign it, Andersen terminated him. The company that bought the tax practice withdrew its employment offer to Edwards. Edwards sued Andersen, alleging, among other things, that the non-competition and TONC agreements were invalid.

The trial court determined all issues of law in favor of Andersen on the merits, and entered judgment in his favor. The trial court specifically decided that (1) the non-competition agreement did not violate section 16600 because it was narrowly tailored and did not deprive Edwards of his right to pursue his profession; and (2) the TONC did not purport to waive Edwards' right to indemnification. Accordingly, the trial court found that requiring Edwards to sign the non-competition agreement and TONC was not unlawful. Edwards appealed the trial court's decision.

The Court of Appeal reversed the trial court and held that the non-competition agreement was invalid because it violated California Business and Professions Code section 16600. The court held that section 16600 prohibits non-competition agreements between employers and employees even where the restriction on future employment is narrowly drawn and leaves a substantial portion of the market available to the employee. The court rejected the Ninth Circuit's "narrow restraint exception" as "a misapplication of California law when applied to an employee's non-competition agreement." The Court of Appeal's decision remanded the case to the trial court to determine if the non-competition agreement may still be enforceable under the trade secret exception to section 16660.

Finally, the court held that the TONC was unlawful because it attempted to waive Edwards' right to indemnity under Labor Code section 2802, which requires employers to indemnify employees for expenses and losses incurred while discharging employment duties. The court held that "requiring Edwards to waive indemnity rights as a condition of continued employment violated public policy and constituted an independently wrongful act." The California Supreme Court granted Andersen's petition for review of the Court of Appeal's decision on November 29, 2006.

Issues the Supreme Court Decided

The *Edwards* Court decided two issues:

1) To what extent does Business and Professions Code section 16600 prohibit employee non-competition agreements?; and

2) Is a contract provision requiring an employee to release "any and all" claims unlawful because it encompasses nonwaivable statutory protections, such as the employee indemnity protection of Labor Code section 2802?

A. Supreme Court Holds That Edwards' Non-Competition Agreement Violates Section 16600 Because It Restricted His Ability To Practice His Accounting Profession.

The Court began its analysis by reviewing the history and application of section 16600. Section 16660 states: "[e]xcept as provided in this chapter, every contract by which anyone is restrained from engaging in a lawful profession, trade, or business of any kind is to that extent void." The Court noted that, since its original enactment, "our courts have consistently affirmed that section 16600 evinces a settled legislative policy in favor of open competition and employee mobility" and that it "protects 'the important legal right of persons to engage in business and occupations of their choosing.'" "[T]his court generally condemns non-competition agreements," said the Court. The Court noted that section 16660 protects Californians and ensures that "every citizen shall retain the right to pursue any lawful employment enterprise of their choice."

Having summarized section 16600's history, the Court wrote "[u]nder the statute's plain meaning, therefore, an employer cannot by contract restrain a former employee from engaging in his or her profession, trade or business unless the agreement falls within one of the exceptions to the rule." Those exceptions are non-competition agreements in the sale or dissolution of corporations (§ 16601), partnerships (§ 16602), and limited liability corporations (§ 16602.5).

The Court rejected Andersen's argument that section 16600 prohibits only broad agreements that prevent a person from engaging entirely in his chosen business, trade, or profession. The cases relied upon by Andersen for this argument embodied the statutory exceptions to section 16600 and extended no further, the Court reasoned.

The Court concluded that the non-competition agreement was invalid because it "restricted Edwards from performing work for Andersen's Los Angeles clients and therefore restricted his ability to practice his accounting profession." The Court found unlawful the non-competition agreement provisions prohibiting Edwards from (1) performing professional services of the type that he had performed at Andersen for any client on whose account he had worked during 18 months prior to his termination, and (2) providing professional services to any client of Andersen's Los Angeles office for one year after termination.

Curiously, although Edwards argued that the so-called "trade secrets" exception to 16600 should be rejected because it relates to an independent body of law, with its own statutory scheme and remedies providing ample protection for employers, the Court noted in a footnote that "[W]e do not here address the applicability of the so-called trade secret exception to section 16600, as Edwards does not dispute that portion of his agreement…." Further, the Court did not address whether restrictions against recruiting workers to work for a competitor violate section 16600.

The Court completely rejected the narrow restraint exception. While acknowledging that the narrow restraint exception had been used by the Ninth Circuit to create an exception to section 16600, the Court noted that no reported California state decision had endorsed the Ninth Circuit's reasoning. "Contrary to Andersen's belief, however, California courts have not embraced the Ninth Circuit's narrow-restraint exception," the Court wrote. "We reject Andersen's contention that we should adopt a narrow-restraint exception to §16600 and leave it to the Legislature, if it chooses, either to relax the statutory restrictions or adopt additional exceptions to the prohibition-against-restraint rule under §16600." The Court distinguished the California state court decisions on which the Ninth Circuit predicated the narrow restraint exception and expressly overruled them to the "extent they are inconsistent with [the Supreme Court's] analysis…."

In its analysis, the Court also rejected the Ninth Circuit's application of the narrow restraint exception in cases such as *International Business Machines Corp. v. Bajorek*, 191 F.3d 1033 (9th Cir. 1999) (upholding an agreement mandating that an employee forfeits stock options if employed by a competitor within six months of leaving employment) and *General Commercial Packaging v. TPS Package*, 126 F.3d 1131 (9th Cir. 1997) (holding that a bargained-for contractual provision barring one party from courting a specific named customer was not an illegal restraint of trade prohibited by section 16600, because it did not entirely preclude the party from pursuing its trade or business). The Court dismissed this concept, noting that "no reported California state court decision has endorsed the Ninth Circuit's reasoning, and we are of the view that California courts have been clear in their expression that section 16660 represents a strong public policy of the state which should not be diluted by judicial fiat."

The Court's disposition of the non-compete agreement issue is broad and unequivocal: "[N]oncompetition agreements are invalid under section 16600 in California even if narrowly drawn, unless they fall within the applicable statutory exceptions of sections 16601, 16602, or 16602.5." Given this broad language, without reference to the so-called "trade secret" exception to section 16600, one might infer that the common law trade secret exception was not included. However, because the Court did not expressly overrule *Muggill v. Reuben H. Donnelley Corp.*, 62 Cal. 2d 239, 242 (1965) and cited *Muggill* for the proposition that section 16600 invalidates employment non-competition agreements unless they are necessary to protect the employer's trade secrets, the trade secret exception should remain viable. California, of course, has a separate statutory framework, Civil Code section 3426 et seq., addressing trade secrets.

B. Supreme Court Holds That A Contract Provision Releasing "Any and All Claims" Generally Does Not Encompass Nonwaivable Statutory Protections.

The Court found that Labor Code section 2804 voids any agreement to waive the protections of Labor Code section 2802 as against public policy. The Court stated that indemnity rights are nonwaivable, and any contract that purports to waive an employee's indemnity right would be contrary to the law and therefore unlawful to that extent.

Because the TNOC did not expressly reference indemnity rights, the Court reasoned that, under well established rules of contract interpretation, it should not be read as encompassing such a waiver in order to render the contract lawful, valid, and capable of being carried into effect.

The Court found that under Labor Code section 2802, a contract provision releasing "any and all" claims generally does not encompass nonwaivable statutory protections.

Thus, the Supreme Court held that the TONC did not purport to release Andersen from any nonwaivable statutory claims, and therefore was not *per se* unlawful under Labor Code sections 2802 and 2804. However, the Court found, even though the TNOC was not *per se* unlawful, Edwards was not precluded from offering proof on remand of facts that might prove Andersen intended to have Edwards waive his Labor Code rights.

What *Edwards* Means For Employers

California employers should be aware that:

1. *Non-competition agreements between employers and employees will be held invalid under section 16600*, even if narrowly drawn, unless they fall within one of the recognized statutory exceptions to 16600. The ruling solidifies how different California's laws are from other states in the areas of employee mobility and competition.
2. *The so-called trade secret exception to section 16600 may remain viable to permit non-solicitation of customer clauses, if the employer can demonstrate that it is necessary to protect its trade secrets.* This exception will likely be tested based on the sweeping language used in the Court's disposition of the non-compete issue. Employers should take special care before including non-solicitation of customer and employee provisions in any employment agreements.
3. *The Court's decision places an increased focus on trade secrets.* The Court's decision may be seen by some employees as allowing greater mobility, even where proprietary information is taken. Auditing your organization's trade secret protections is a valuable first step toward protecting against this risk and ensuring that your organization's intellectual capital is adequately protected.
4. *Contracts providing for ancillary restraints on employees*—such as forfeiting stock options or other benefits if the employee joins a competitor—*are likely not enforceable.*
5. *Agreements between employees and employers should be reviewed* to determine whether they impermissibly restrict employees' rights to engage in competitive and employment activities. In-house counsel and human resource personnel should consult with their Seyfarth attorney regarding the review of such agreements and before sending demand letters or commencing litigation concerning such agreements. Employers with restrictive covenants *unnecessary to protect genuine trade secrets run the risk not only of courts invalidating the agreements, but also of being sued for interfering with an employee's ability to obtain a new job.*
6. *Be aware that agreements with employees "waiving any and all" claims do not per se* cover nonwaivable statutory protections such as the employee indemnity protections of Labor Code section 2802.

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